

MEMORANDUM OF LAW

DATE: March 31, 1992

TO: Bruce Herring, Deputy City Manager; Joe Lozano, Assistant Auditor & Comptroller

FROM: City Attorney

SUBJECT: City's Federal Income Tax Obligations Pertaining to City Store

This memorandum is to follow up on our meeting of March 10th in the City Attorney's conference room on the issue of the City's federal income tax obligations for goods sold at the City Store.

By way of background, I note that when the concept of the City Store was first discussed last fall, both the City Attorney and Auditor had questions about the City Store's potential federal income tax obligations. I understand from prior conversations and from our March 10th meeting that the City Manager's preferred position is not to pay federal income tax on the goods sold at the City Store.

Following our early meetings on the City Store, the City Attorney assigned a senior legal intern to conduct legal research on the topic. The legal intern found that as a general rule cities are exempt from federal income taxes, except when they engage in certain business-type activities. Internal Revenue Code section 115. If a city's business activities can be fairly characterized as serving "essential government functions," the business activities will not be subject to federal income taxation, even though those activities share some of the characteristics of a private business enterprise. The intern's research of relevant case law and IRS tax rulings yielded inconclusive results as to when a city's "business type activities" will be subject to federal income taxation and when they will not.

Although the intern's extensive legal research yielded mixed results, I believe that the Manager's preferred position is legally defensible under the "governmental function" exception. Among other reasons, I believe that a legitimate governmental purpose is served by selling surplus City goods at the City Store, especially since the rate of return is generally higher than that from auction sales of the same type of goods. I also believe that the promotion of tourism is a legitimate governmental purpose which is well served by the City Store.

In short, if the IRS challenges the City's decision not to pay federal income tax, assuming any were due in the first place, I believe that there are sufficient facts to support a finding that the City is entitled to an exception under the governmental purpose doctrine and the

City is therefore not obliged to file or pay federal income taxes on goods sold at the City Store.

JOHN W. WITT, City Attorney

By

Cristie C. McGuire

Deputy City Attorney

CCM:js:jrl:013(x043.2)

ML-92-28